Office of Chief Counsel Internal Revenue Service

memorandum

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date:

to: Joe Jason, Internal Revenue Financial Products Specialist, and Pat Perrone, Internal Revenue Agent

from: Associate Area Counsel (LMSB), Chicago

Subject: Opinion - Substance Over Form - Preferred Stock Acquisition

Taxpayer:

This memorandum responds to an on-going request for assistance. We have been coordinating with Foreign Joint Ventures Industry Counsel Sergio Garcia-Pages regarding the effectiveness and consequences of the check the box election and the preferred shareholding transactions. This memorandum should not be cited as precedent.

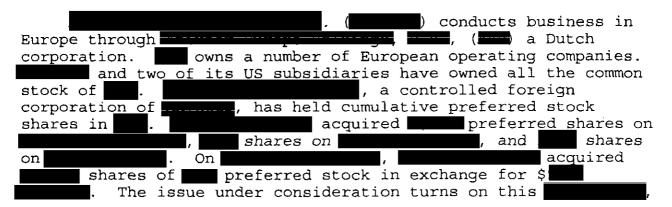
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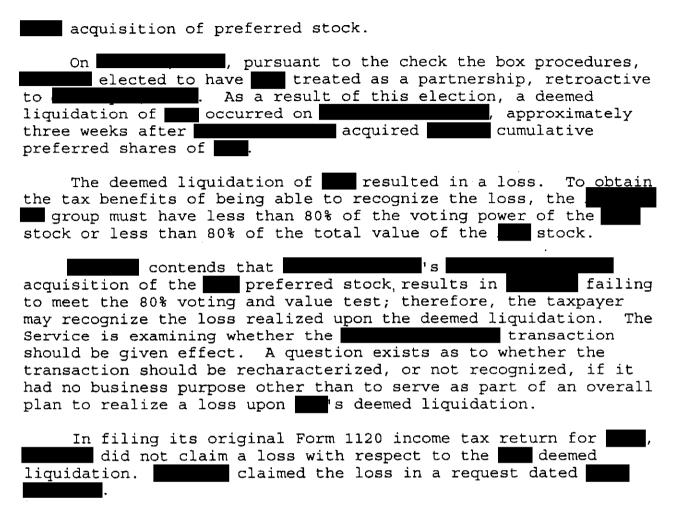
Whether certain transactions should be ignored or recharacterized to properly account for the substance of an overall scheme that had no business purpose other than to generate tax advantages.

CONCLUSION

The transactions should not be ignored or recharacterized.

Facts





ANALYSIS

The substance of a transaction, rather than its form, determines tax consequences

The Supreme Court has held that the tax effect of a transaction depends upon its substance, and that permitting "the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). The Court will not "exalt artifice above reality."

Gregory v. Helvering, 293 U.S. 465, 470 (1935). If the form of a transaction is unreal or a sham, the Service "may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." Higgins v. Smith, 308 U.S. 473, 477 (1940).

Under certain circumstances, the IRS may deal with purportedly separate steps as integrated. Determining the true nature of a set of transactions and their proper tax consequences

may require linking together the interrelated transactions, rather than treating each in isolation. See Commissioner v. Clark 489 U.S. 726, 738 (1989); Kornfeld v. Commissioner, 137 F.3d 1231 (10th Cir. 1998) aff'q T.C. Memo. 1996-472.

The law also recognizes that a taxpayer may structure a transaction in a manner that minimizes the tax consequences thereof. Gregory v. Helvering, 293 U.S. 465, 469 (1935); ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 513 (D.C. Cir. 2001). A tax avoidance purpose or motive does not vitiate a transaction. Granite Trust Co. v. United States, 238 F.2d 670, 675 (1st Cir. 1956).

In Esmark, Inc. & Affiliated Cos. v. Commissioner, 90 T.C. 171, 183 (1988), aff'd without published opinion 886 F.2d 1318 (7th Cir. 1989) the tax court said that "Congress enacted a statute under which tax consequences are dictated by form; to avoid those consequences, [the Commissioner] must demonstrate that the form chosen by [the taxpayer] was a fiction that failed to reflect the substance of the transaction." The tax court has said that it "will not disregard the form of the transaction if it accounts for the transaction at least as well as alternative Turner Broadcasting System, Inc. v. recharacterizations." Commissioner, 111 T.C. 315, 326 (1998) (footnote omitted). government may combine meaningless steps, but it may not create steps that never occurred. Grove v. Commissioner, 490 F.2d 241, 247-48 (2d Cir. 1973), aff'g T.C. Memo 1972-98; Turner Broadcasting 111 T.C. at 327-328. The Service has ruled that

[t]he step transaction doctrine generally permits a series of formally separate steps to be amalgamated and treated as a single transaction if they are in substance integrated, interdependent, and focused toward a particular end result.

. . [T]hreshold steps will not be disregarded under a step transaction analysis if such preliminary activity results in a permanent alternation of a previous bona fide business relationship. Thus the substance of each of a series of steps will be recognized and the step transaction doctrine will not apply, if each such step demonstrates independent economic significance, is not subject to attack as a sham, and was undertaken for valid business purposes and not mere avoidance of taxes.

Rev. Rul. 79-250, 1979-2 C.B. 156.

 The step transaction doctrine allows for the recasting of a series of transactions to properly account for its overall substance The step transaction doctrine applies when the taxpayer seeks a tax benefit through the use of meaningless steps or through some other fiction. The meaningless steps are ignored or recast when part of a single transaction. Turner Broadcasting System, Inc. v. Commissioner, 111 T.C. 315, 327 (1998) (steps not recast when the transactions did not involve "a tax fiction, a misalignment of the parties rights and the form adopted by them, a meaningless step, or a nonbusiness purpose").

A momentary or temporary step that is part of a series of transactions often signals a substance over form problem. The step transaction doctrine may ignore the transitory step if the step has no meaning or if it merely serves as means of achieving an ultimate end. See Associated Wholesale Grocers, Inc. v. United States, 720 F. Supp. 887 (D. Kan. 1989) (the momentary exchange of assets lacked independent significance or meaning, other than to serve as a basis for claiming a tax benefit). McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982), McDonald's Corporation wanted to acquire a holding of restaurant franchises. The owners wanted cash for its restaurants, while McDonald's wanted an exchange of The parties agreed that McDonald's would give shares of unregistered McDonald's common stock and that the stock could be included and sold in an upcoming registration. The seventh circuit (reversing the tax court) agreed that McDonald's could combine steps to treat the transaction as a purchase (rather than a merger), allowing McDonald's a step-up in basis equal to its cost (the value of the common shares it conveyed for the restaurants). The court noted that the sellers of the restaurants wanted cash and that they would not have entered into the transaction without the provisions allowing them to sell the McDonald's common stock at an upcoming registration. This case is unusual in that it ignores a step that had independent significance; however, it serves as an example of how an intermediate step of temporary duration may be ignored to reflect the substance of the transaction.

A particular step in a series undertaken pursuant to an overall plan may be disregarded if the taxpayer could have reached the same result more directly and the step merely serves as a tax avoidance device. Del Commercial Properties, Inc. v. Commissioner, 251 F.3d 210 (D.C. Cir. 2001). The step transaction doctrine has served as the basis for disregarding intermediaries or conduits, where a taxpayer uses the intermediary or conduit in an effort to obtain a tax benefit that would not otherwise be available. Packard v. Commissioner, 85 T.C. 397, 420 (1985); Del Commercial Properties, Inc. v. Commissioner, T.C. Memo. 1999-441.

On the other hand, if the substance of the transaction follows its form, a court will respect the form. Turner Broadcasting System, Inc. v. Commissioner, 111 T.C. 315, 326 (1998); Esmark, Inc. and Affiliated Cos. v. Commissioner, 90 T.C. 171 (1988), aff'd without published opinion 886 F.2d 1318 (7th Cir. 1989). The taxpayer's being unaware of the tax benefit at the time of the transaction suggests that the transaction was motivated by a business, rather than a tax, purpose. See Turner Broadcasting System, Inc. v. Commissioner, 111 T.C. at 327 (the transactional parties were unaware of the tax benefit when they created the transactional documents, a fact indicating a business, rather than a tax avoidance, purpose).

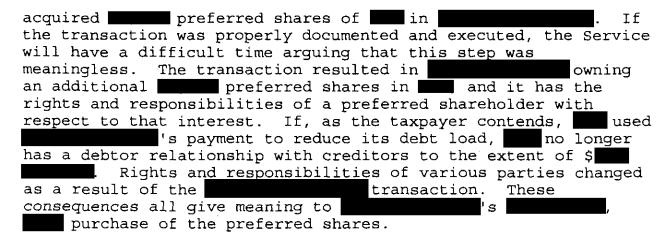
In determining the appropriateness of recasting the steps of a transaction, courts have used three tests. These are the end result, interdependence, and binding commitment tests.

The end result test combines purportedly separate steps into a single transaction. The taxpayer undertakes the series of steps as part of a plan to achieve a specific result. See Redding v. Commissioner, 630 F.2d 1169 (7th Cir. 1980) rev'g 71 T.C. 597 (1979). The test looks at whether "a series of formally separate steps are really prearranged parts of a single transaction intended from the outset to reach the ultimate result." Penrod v. Commissioner, 88 T.C. 1415 (1987). The test looks at the intent of the taxpayer at the start of the transactions.

The interdependence test looks at the relationship between the steps of a transaction to determine whether each step had independent significance, or whether each step had meaning only as a part of the whole transaction. Redding v. Commissioner, 630 F.2d 1169 (1980) rev'g 71 T.C. 597 (1979); Penrod v. Commissioner, 88 T.C. 1415 (1987). The consequences of the intermediate transactions have significance only upon completion of the series. The test focuses "on the relationship between the steps, rather than on the 'end result'." McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520, 524 (7th Cir. 1982) rev'g 76 T.C. 972 (1981).

The most restrictive of the three tests, the binding commitment test, is used least by courts. The test looks at whether, prior to taking the series of steps, the parties have bound and committed themselves to reach a specific last step. Commissioner v. Gordon, 391 U.S. 83, 96 (1968); Redding v. Commissioner, 630 F.2d 1169 (1980); Penrod v. Commissioner, 88 T.C. 1415 (1987).

Here, in exchange for \$



After the deemed dissolution of did not possess the shares for a temporary period, ending upon some some dissolution. Acquisition of the preferred shares was not conditional upon some sort of dissolution of the we do not have a situation where the taxpayer seeks tax consequences resulting from a fleeting or temporary step that had no meaning.

It is also difficult to argue that motivation purpose at the time purchased the preferred shares. At the time Anixter filed its original Form 1120 it did not claim a loss from the deemed liquidation. The lack of a tax motivation purpose suggests that the preferred shares were purchased for non-tax business reasons.

3. Generally, it is permissible to alter holdings in a subsidiary in order to obtain § 332 tax benefits not otherwise obtainable

Pursuant to I.R.C. § 332, a taxpayer recognizes no gain or loss upon liquidation of a subsidiary if i) the taxpayer possesses at least 80% of the total voting power of the subsidiary stock and ii) the stock possessed by the taxpayer constitutes at least 80% of the total value of all the subsidiary stock. I.R.C. §§ 332 and 1504(a)(2). The taxpayer recognizes gain or loss upon the liquidation of a corporation in which the taxpayer has an interest if the taxpayer fails to meet either the 80% voting test or the 80% value test.

Generally, the step-transaction doctrine does not apply when a taxpayer engages in transactions to acquire or dispose of subsidiary stock in order to fall under or avoid the 80% voting and value test. The IRS (in certain rulings) and courts have allowed corporations to take steps to obtain tax benefits not otherwise available under I.R.C. §§ 332 and 1504(a)(2) (and their

predecessors).

In <u>Commissioner v. Day & Zimmermann</u>, Inc., 151 F.2d 517 (3d Cir. 1945) the taxpayer owned more than 80% of each of two corporations. Wanting to liquidate the corporations and realize losses thereon, the taxpayer took steps to reduce its holdings to below 80% for each corporation. An auctioneer sold some of the stock of each of the two corporations to the taxpayer's treasurer. He purchased a sufficient number of shares to drop the taxpayer's interest in each of the corporations to below and the court allowed the taxpayer to recognize losses upon the subsequent liquidations.

In Avco Manufacturing Corporation v. Commissioner, 25 T.C. 975 (1956) the taxpayer sold some shares of stock it owned in a subsidiary in order to avoid the statutory requirements for the nonrecognition of loss. The court found the sale effective and concluded that the taxpayer could recognize a loss upon the subsequent liquidation. The tax motivation and a lack of a business purpose for the sale did not require the court to ignore the sale for purposes of determining the tax consequences of the subsequent liquidation.

In <u>Granite Trust Co. v. United States</u>, 238 F.2d 670 (1st Cir. 1956) the taxpayer Granite Trust Co. owned all the stock of Building Corporation. Granite Trust wanted to liquidate Building Corporation, which would result in a loss. On December 6, 1943, the taxpayer sold 20.5% of the Building Corporation stock. On December 17, 1943, in the course of the final liquidation of Building Corporation, the buyer surrendered its certificate for 20.5% of the stock. The taxpayer in <u>Granite Trust</u> admitted that it sold 20.5% of the stock to a friendly party in order to obtain the tax benefit of loss recognition. The taxpayer admitted that the purchaser of the stock knew of the plan to liquidate Building Corporation before the end of the year.

In <u>Granite Trust</u> the IRS argued that the transaction should be treated as Granite Trust's complete liquidation of its wholly owned subsidiary. The IRS argued that the intermediate steps should be ignored, where the taxpayer sold 20.5% of the Building Corporation stock on December 6, only to have this same stock surrendered upon final liquidation on December 17. The IRS argued that the intermediate steps had no independent purpose or meaning, and merely constituted transitory steps for the purpose of avoiding taxes. The court held that a purpose to avoid taxes is not an illicit motive. <u>Granite Trust Co. v. United States</u>, 238 F.2d at 675. The court noted that the Code had specific requirements for the nonrecognition of gain or loss upon liquidation. Failure to meet one of the rigid requirements, such

as 80% ownership, resulted in recognition of gain or loss.

The court also found support for its position in the legislative history of I.R.C. § 332. Section 332 corresponded to § 112(b)(6) of the 1939 Code. Section 112(b)(6) included a second condition for nonrecognition of gain or loss. § 332, Congress retained the 80% voting and value requirement. but eliminated the second condition. With respect to eliminating the second condition, the Report of the Senate Finance Committee stated that the "committee has removed this provision with the view to limiting the elective features of the section". Trust Co. v. Commissioner, 238 F.2d at 676, quoting Sen. Finance Committee Report, H.R. 8300, 83rd Cong., 2d Sess. 255 (1954). The court found that the language in the committee report shows a legislative understanding "that taxpayers can, by taking appropriate steps, render the subsection applicable or inapplicable as they choose, rather than be at the mercy of the Commissioner on an "end-result" theory. 238 F.2d at 676. court interpreted the legislative history as recognizing the ability of a taxpayer to elect either recognition or nonrecognition treatment by adjusting its percentage holdings in a subsidiary prior to liquidation. For purposes of § 332, it is permissible for a taxpayer to engage in a series of transactions established to achieve a specific end result.

The tax court also has found the recognition/nonrecognition rules of I.R.C. § 332 "elective". It has said "we conclude that section 332 is elective in the sense that with advance planning and properly structured transactions, corporations should be able to render section 332 applicable or inapplicable." Riggs v. Commissioner, 64 T.C. 474, 489 (1975), acq. 1976-2 C.B. 2. In Riggs the taxpayer corporation took steps to increase its ownership of a subsidiary to meet the requirements of I.R.C. § 332. The taxpayer's subsequent liquidation of the subsidiary produced nonrecognizable gain.

Rev. Rul. 78-285, 1978-2 C.B. 137 cites with approval Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956). In the facts of the revenue ruling, a shareholder unconditionally sold to an unrelated buyer a number of shares sufficient to reduce the taxpayer's interest in the corporation below the 20% limitation that existed in I.R.C. § 341(e)(4)¹ at the time. With respect to a transaction occurring a few days later, the Service recognized the sale as reducing the shareholder's holdings in the

¹ In 1986, P.L. 99-514, § 631(e)(6)(A) deleted this provision. Rev. Rul. 95-71, 1995-2 C.B. 323, obsoleted Rev. Rul. 78-285.

corporation to below 20% for purposes of applying I.R.C. § 341(e)(4). The revenue ruling recognizes an ability on the part of a taxpayer to plan in advance and structure transactions in such a way as to render a Code section applicable or inapplicable. The Service has treated § 332 similarly, as indicated in (non-precedential) letter rulings.² Though non-precedential, the letter rulings reflect a reasoning that would apply in the case.

In Ltr. Rul. 8428006 the IRS, citing Granite Trust, permitted the "absolute, unconditional, non-contingent, and unrestricted" sale of 331/3% of the stock of a wholly owned subsidiary, where the parent corporation sold the stock to avoid § 332(a) nonrecognition of loss treatment upon the subsequent liquidation of the subsidiary. The taxpayer corporation sold the stock of its subsidiary on February 20, 1979 to an unrelated purchaser. The negotiations leading to sale were at arm's length with an unrelated purchaser. Separate and independent counsel represented both the seller and purchaser. Subsequent to the stock sale, the subsidiary began a liquidation process that was completed by March 28, 1979. At the time of the sale the purchaser paid cash of \$40,000 and gave an unsecured note payable for \$160,000 plus 10% annual interest. The note was paid in the Fall of 1979 (after the liquidation). The Service found the transaction a permissible means of obtaining nonrecognition of loss treatment.

4. To argue that beneficially owned the preferred shares, the Service would need to show that so ownership was transitory and/or not genuine

The owner of property is the possessor of the beneficial interest (dominion and control), and not the one holding mere legal title. Macon, Dublin & Savannah Railroad Co. v. Commissioner, 40 B.T.A. 1266, 1273 (1939), acg., 1940-1 C.B. 3; Mitchell Aero, Inc. v. City of Milwaukee, 42 Wis. 2d 656, 168 N.W.2d 183, 185-186 (1969); In re Stoffregen, 206 B.R. 939, 942 (Bankr. E.D. Wis. 1997). The conveyance of legal title without the conveyance of beneficial ownership fails to effect a transfer. See J.H. Baird Publishing Co. v. Commissioner, 39 T.C.

² Private letter rulings may not be used or cited as precedent. I.R.C. § 6110(k)(3). Some courts have said that PLRs may be used "as evidence of administrative interpretation", Commerica Bank, N.A. v. U.S., 93 F.3d 225, 230 (6th Cir. 1996) or "when evaluating the consistency of application of statutes", Phi Delta Theta Fraternity v. Commissioner, 887 F.2d 1302, 1308 (6th Cir. 1989).

608, 618 (1962), <u>acq.</u>, 1963-2 C.B. 4 (deed conveyed only legal title while the taxpayer retained beneficial ownership).

Qualifying as a member of an affiliated group for purposes of consolidated returns requires meeting the Code's 80% voting and value test. I.R.C. § 1504(a). In determining direct ownership for purposes of the voting and value test, the law looks at beneficial ownership. Miami National Bank v. Commissioner, 67 T.C. 793 (1977); Rev. Rul. 84-79, 1984-1 C.B. 190. The 80% may be met if a corporation meets the requirements of I.R.C. § 1504(a) through beneficial ownership, even though it lacks legal title to the stock of a subsidiary.

In <u>Granite Trust Co. v. Commissioner</u>, 238 F.2d 670 (5th Cir. 1956) (discussed above) the government also argued that the sale of 20.5% of the subsidiary stock transferred title to the stock but not beneficial ownership. The government argued that without transfer of the beneficial ownership, and as a transitory step in a tax avoidance scheme, the sale should not be recognized. The court rejected the argument, finding no evidence that the parties meant to keep beneficial ownership with the taxpayer. The court determined that the 20.5% of the subsidiary stock sold to a friendly buyer would have been attachable by the buyer's creditors, includible as an asset should the buyer have initiated a bankruptcy proceeding, and includible in an estate that would have resulted if the buyer had died.

Ltr. Rul. 9206005 involves a situation where a US parent corporation owned various subsidiary corporations, including one (Sub 1) that solely owned a US holding corporation (Sub Holding). The US parent filed a consolidated return with its includible The US parent was solely owned by Foreign Parent, a affiliates. foreign corporation. For tax planning reasons, the related corporations wanted to separate Sub Holding from the consolidated group. Through recapitalization and stock dividend distributions, 25% of the voting stock of Sub Holding was transferred to Foreign Parent. The transfer occurred for tax planning reasons. With the foreign parent owning 25% of its value, Sub Holding was no longer includible in the U.S. parent's consolidated group. This allowed for certain tax consequences desired by the related group. The Service found that transfer of 25% of the stock of Sub Holding to Foreign Parent (through recapitalization and stock dividend distributions) worked to break Sub Holding's consolidation with its US parent, and allowed it and its subsidiaries to file a separate consolidated return. The tax planning motivation was found to be irrelevant since Foreign Parent's 25% stock ownership was "genuine and not transitory".

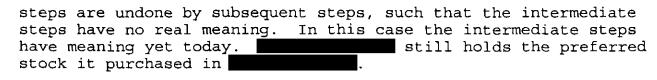
5. The facts of the case do not make a strong case for applying any substance over form doctrines

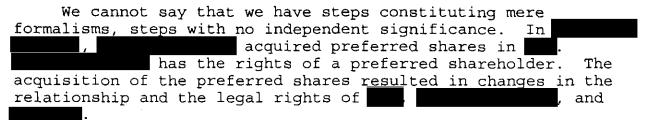
The various events did not make for an orderly arrangement where the steps are clearly part of related transactions. We have elected to treat as a partnership in partnership in the par

The facts and circumstances do not strongly suggest that these various steps are interdependent.

purchase of preferred stock in can stand on its own. The purchase was not conditional, it did not depend upon the purchase resulting in shaving shav

We do not have a situation where transitory intermediate





The government may quibble with the business purpose for the preferred share acquisition. We would like to argue that the sole purpose of the acquisition was to allow to realize a loss on the deemed liquidation. The taxpayer argues that the stock purchase was necessitated by a need to replace debt with capital. Says we used the cash from stock purchase to reduce so intercompany debt load. Replacing debt with equity allowed to meet minimum capitalization requirements of certain European countries. Also, the taxpayer's not claiming a loss on its original Form 1120 suggests that the preferred stock purchase was motivated by business reasons.

In any event, as courts and the IRS have both viewed § 332 as elective, a lack of business purpose for acquisition of the preferred shares is probably irrelevant. It is permissible for a taxpayer to dispose of stock in a subsidiary prior to liquidation in order to obtain recognition of loss treatment.

We know of no basis for contending that ownership of the preferred stock is not genuine. Without additional facts showing otherwise, we assume that the preferred shares are attachable by the shares would be includible as an asset in an bankruptcy or insolvency proceeding. We cannot argue that the shares, rather than the shares.

We have concluded that the facts as we know them do not allow the Service to use a substance over form basis for ignoring or recasting the acquisition of preferred shares by If you have any questions on this matter, please call Michael Calabrese of this office at (414) 297-4241.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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Ву:	
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